SUPREME COURT, U. S.
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No. 73-1828

In the

Supreme Court of the United States

OCTOBER TERM, 1973

OLGA HOCHFELDER, et al.,

Petitioners,

vs.

MIDWEST STOCK EXCHANGE,

Respondent,

LEON S. MARTIN, et al.,

Petitioners,

vs.

MIDWEST STOCK EXCHANGE,

Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPPEALS FOR THE SEVENTH CIRCUIT

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To the Chief Justice of the United States and the Associate Justices of the Supreme Court of the United States:

Petitioners respectfully pray that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Seventh Circuit entered in this proceeding on 10 April 1974.

OPINIONS BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit has not yet been officially reported. It is attached to this petition as Appendix A. The opinion of the United States District Court for the Northern District of Illinois is reported at 350 F. Supp. 1122.

JURISDICTION

The judgment of the Court of Appeals was entered on 10 April 1974. The mandate has been stayed to and including 7 June 1974. The jurisdiction of this Court is invoked under Title 28 U.S.C. § 1254(1).

QUESTIONS PRESENTED

1. Is a federally regulated stock exchange immune from liability for fraud perpetrated by one of its members, where the exchange vouched for his integrity and despite adequate notice, failed to investigate his improprieties?

2. Is a summary judgment a proper means for avoiding a trial on the questions:

   (a) Whether plaintiffs, in fact, relied to their detriment on representations by respondent as to the honesty and integrity of one of respondent's members?

   (b) Whether the respondent's failure to investigate, despite notice of facts casting doubts on its member's reliability and responsibility, constituted negligence?

STATUTORY PROVISIONS

The statutes and regulations involved are: Section 6 of the Securities Exchange Act of 1934. (15 USC §78 f)

As a condition of its registration, an Exchange must file with the Commission "An agreement . . . to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder".

Sub section (b) of § 78 f provides: "No registration shall be granted or remain in force unless the rules of the exchange include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade, and declare that the willful violation of any pro-

visions of this chapter or any rule or regulation thereunder shall be considered conduct or proceeding inconsistent with just and equitable principles of trade."

Sub section (d) of §78 f provides "If it appears to the Commission . . . that the rules of the exchange are just and adequate to insure fair dealing and to protect investors, the Commission shall cause such exchange to be registered as a national securities exchange".

Rule 56 of the Federal Rules of Civil Procedure on Summary Judgment provides: "The judgment sought shall be rendered forthwith if the pleadings, depositions, answers to interrogatories, and admissions on file, together with the affidvits, if any, show that there is no genuine issue as to any material fact and that the moving party is entitled to a judgment as a matter of law."

STATEMENT

This case comes to this Court from a grant of summary judgment by the trial court and an affirmance of that judgment by the Court of Appeals. It is important, therefore, that this Court recognize that "all inferences of fact from the proofs proferred at the hearing must be drawn against the movant [respondent] and in favor of the party opposing the motion [petitioners]." 6 Moore's Federal Practice ¶ 56.13[3].

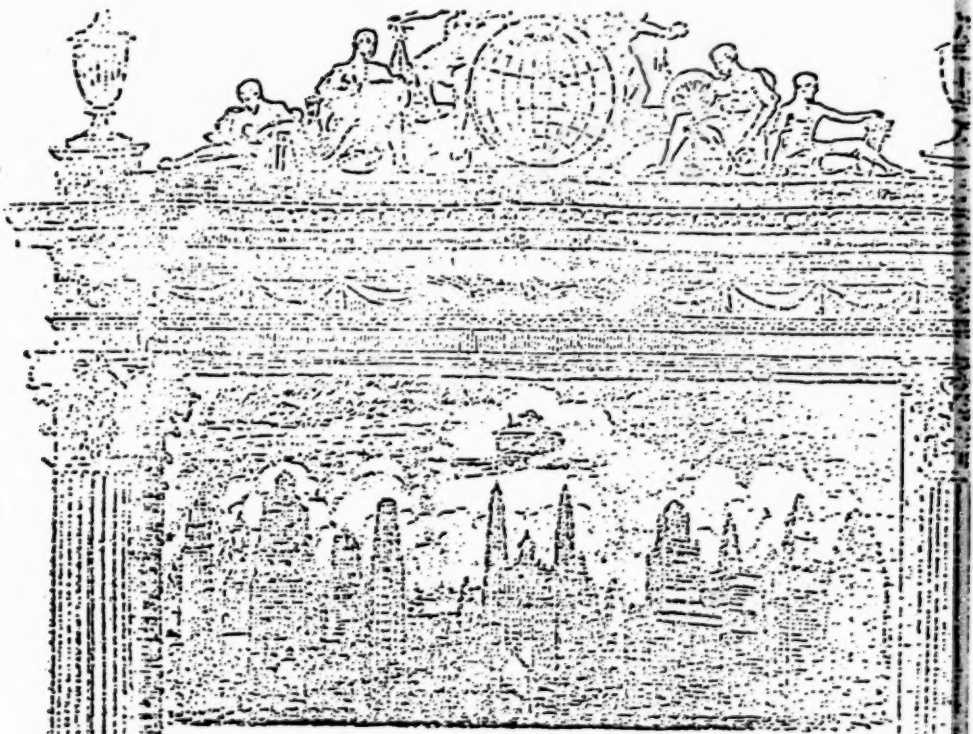
Petitioners are the victims of a securities fraud in the sale to them of fictitious securities in the amount of $1,073,000, perpetrated upon them over a 19 year period by the late Leston B. Nay, while he was President of First Securities Company of Chicago ("First Securities"). The fraud was uncovered only by Nay's suicide. Both First Securities and Nay were members of the Midwest Stock Exchange ("Midwest"), the respondent here.

The fraud perpetrated by Nay was a violation of the Securities Exchange Act of 1934. Both Nay and First Securities were held to have violated that statute, Nay as principal and First Securities by its failure to fulfill its

fiduciary obligations under the federal law. *S.E.C.* v. *First Securities Co. of Chicago*, 463 F. 2d 981 (7th Cir. 1972). In that case the Court of Appeals for the Seventh Circuit, upsetting the finding of the special master, held that First Securities was liable because Nay had apparent authority to act on behalf of First Securities. That apparent authority rested largely on Nay's use of letterhead bearing First Securities' name. "Some of the letterhead stationery included the words, 'Leston B. Nay, President,' on the upper left hand portion thereof. All of the stationery bore the legend, 'Member Midwest Stock Exchange,' in addition to the firm's name and address." 463 F. 2d at 984. The Seventh Circuit also held First Securities liable for the fraud because it "failed to satisfy its duty to supervise Nay pursuant to Rule 27 of the Rules of Fair Practice of the National Association of Securities Dealers, Inc." *Id.* at 986.

Petitioners here have asserted grounds for liability against the respondent similar to those that they successfully asserted against First Securities in the earlier action. Although the record evidence is at least as strong against Midwest as against First Securities, the same Court that ordered judgment against First Securities has rejected petitioners' claims against Midwest. It sustained respondent's motion for summary judgment although, at the very least, petitioners were entitled to have the substantial factual questions raised considered by a jury.

The frauds perpetrated by Nay were effected under the aegis of the respondent. As the Court of Appeals noted in the earlier case, every letterhead used by Nay bore the words: "Member Midwest Stock Exchange." There is no question that this was authorized by respondent. Moreover most of these sales were made in Nay's office under a large plaque issued by respondent and certifying Nay's "commercial honor and integrity." The plaque looks like this:



MIDWEST STOCK EXCHANGE

ORGANIZED 1882

AN ASSOCIATION OF BROKERS, WHOSE OBJECT IS TO ESTABLISH AND CONDUCT A MARKET FOR LISTED SECURITIES, WHERE HIGH STANDARDS OF COMMERCIAL HONOR AND INTEGRITY ARE MAINTAINED AND JUST AND EQUITABLE PRINCIPLES OF TRADE AND BUSINESS PREVAIL.

THIS CERTIFICATE OF MEMBERSHIP IS ISSUED TO

LESTON B. NAY

OF

FIRST SECURITIES COMPANY OF CHICAGO

Thus, did respondent cloak Nay with the indicia of responsibility and honesty that made it possible for him to mulct the petitioners. (cf. *Gizzi* v. *Texaco, Inc.*, 437 F. 2d 308 3d Cir 1971). Petitioners asserted their reliance on these respresentations and neither the lower courts nor the respondent may contradict such allegations in light of the fact that the case was decided in favor of respondent on summary judgment.

So, too, the facts asserted by petitioners relating to the failure of the respondent to exert the required supervisory functions with which it is charged by law are here uncontestable in light of the fact that the courts below resolved the case in respondent's favor on a motion for summary judgment. On this issue, the Court of Appeals offered petitioners only Hobson's choice. By its ruling on summary judgment the court precluded the possibility of proof and then proceeded to rule: "Failing proof that Midwest knew or should have known of Nay's fraud we need not further our inquiry into the other elements of a claim for aiding and abetting solely by inaction." (App. p. A-16) And again: "Absent proof of negligence, we will not stand in willingness to impose a standard of strict liability." *(Ibid.)* We respectfully submit that a motion for summary judgment cannot be rested, without evidence being taken, on the court's determination of the jury question whether the respondent's acts of commission and omission constitute negligence or aiding and abetting the perpetration of the fraud.

In effect the Court of Appeals for the Seventh Circuit has ruled as a matter of law that Midwest cannot be held responsible to petitioners for the fraud perpetrated on them, although that fraud might have been avoided or

cured had Midwest performed the fiduciary obligations of oversight of its members' behavior that the national securities laws impose on such stock exchanges. This ruling was predicated in the face of these undisputed facts among others:

(1) When Nay was admitted to the Midwest Exchange in 1945, Midwest made only a cursory inquiry as to his integrity and financial status. It obtained no commercial report on Nay as it did on all salesmen of its members.

(2) From 1957 to 1968, Nay borrowed from First Securities large portions of its capital without repaying the loans. Most of the loans were reported to Midwest as required by its regulations, but it made no inquiry into the ever-growing and unpaid "loans to officer" that were thus reported and it never inquired into Nay's financial status.

(3) In 1959, Nay requested permission from Midwest to pledge all his First Securities stock (92% of all its stock) for a bank loan. The request was denied, but Midwest still made no inquiry into Nay's financial condition that gave rise to the request for such permission.

(4) In the Fall of 1967, Ernst & Ernst reported to Midwest that as of October 31, 1967, First Securities had a net capital deficiency of $9,000. Midwest advised Ernst & Ernst that the audited statement need not show this deficiency because it was later cured. Again, Midwest made no inqury as to the obvious financial difficulties that First Securities was suffering. Indeed, Midwest failed to enforce its rule requiring monthly statements from any firm member whose net capital had fallen below the minimum required by Midwest. It preferred to ignore the facts of financial difficulty.

We respectfully submit that the petitioners were entitled to a trial on the facts as to whether the action and inaction of the respondent constituted a violation of its duty to enforce compliance by its members with the Securities Act and whether the action and inaction of respondent constituted such negligence as to impose liability on Midwest for its failure to investigate and act on Nay's defalcations and those of First Securities. The Court of Appeals has in effect ruled that whatever the misbehavior of an individual member of the exchange, Midwest is not required to investigate that misbehavior or to withdraw its imprimatur from his conduct of business with the public, which knows only of the representations of character and integrity of that member made by the exchange.

REASONS FOR GRANTING THE WRIT

I. THE QUESTION PRESENTED HERE OF STANDARDS OF RESPONSIBILITY OF STOCK EXCHANGES FOR THE FRAUD OF THEIR MEMBERS IS ONE OF WIDE IMPACT AND IMPORTANCE.

Ever since Richard Whitney's scandalous behavior revealed the great need for federal regulation of stock exchanges and their members, (see *Baird* v. *Franklin*, 141 F. 2d 238, 2d Cir. 1944) both the Congress and this Court have been vigilant to see that the law's protection of stock exchange customers is meaningful and not merely hortatory. The need for review of the kind of question presented by this case is established by the grants of certiorari and subsequent decisions of this Court in *Silver* v. *New York Stock Exchange*, 373 U.S. 341 (1963); *S.E.C.* v. *Capital Gains Bureau*, 375 U.S. 180 (1963); *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967); *S.E.C.* v. *National Securities, Inc.*, 393 U.S. 453 (1969); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375 (1970). It is primarily in a declining market of the kind witnessed over recent years that the question of an exchange's liability to its members' customers arises.

There can be no doubt that §6 of the Securities Exchange Act of 1934, 15 U.S.C. §78f. was enacted to make the exchanges responsible "to insure fair dealing and to protect investors" (§6d). Section 6 thus imposes obligations on the exchanges to secure proper behavior on the part of their members. Section 6 requires an exchange "to enforce so far as within its powers compliance by its

members" with that Act. This Court has referred to that provision as a "federally mandated duty of self policing by exchanges" (*Silver* v. *N.Y. Stock Exchange*, 373 U.S. 341, 352 (1963)). The decision below would severely limit that obligation by assuring that an exchange which chose "to see no evil" on the part of its members could exonerate itself from liability.

The decision below finds that there can be no liability on the part of an exchange that did not know or have reasonable cause to know that a member was breaching his fiduciary obligations to clients. And it then goes on to hold that petitioners are precluded from offering proof to a trier of fact that there was reason to know that its member was engaging in shady deals. It reached its conclusion as a matter of law and in the face of its own summary of evidence that would clearly put the exchange at least under an obligation of inquiry, an inquiry which the exchange steadfastly refused to undertake. From the time of his admission to membership to the moment of his suicide—and even thereafter—the exchange made no inquiry whatsoever into the qualifications or misbehavior of the perpetrator of the gross frauds involved here. Midwest claims and was granted exoneration from liability because it chose not to discover what inquiry would have revealed about the shaky financial position and improper behavior of Nay. The Court will, indeed, be returning to the period antedating Richard Whitney if it fails to upset the holding that, as a matter of law, Midwest could choose to remain ignorant of Nay's behavior and thus relieve itself of any responsibility for misbehavior.

II. THE DETERMINATION OF THE BASIC AND SUBSTANTIAL QUESTIONS OF FACT BY SUMMARY JUDGMENT, AS WAS DONE IN THE COURTS BELOW, FLIES IN THE FACE OF THE DECISIONS OF THIS COURT REQUIRING TRIAL OF SUBSTANTIAL ISSUES OF FACT WHERE THEY EXIST.

The Court of Appeals recognized that the liability of the respondent under Section 6 turned on whether it "should have known" facts sufficient to put it on inquiry into Nay's behavior. After reviewing the facts alleged, it ruled: "Viewing this event with all the other asserted warnings, we are not convinced that *in toto* they were sufficient to put Midwest on notice that further inquiry was warranted." (App. p. A11.) The trial court, on the other hand had asserted that Midwest was "arguably put on notice of Nay's untrustworthiness." 350 F. Supp. at 1124. With all respect, it was not for the Court of Appeals to make such determination of a substantial issue of fact on summary judgment.

The Court of Appeals did not even deign to decide "the question of the scope of Midwest's representation through the medium of the plaque or the reasonableness of plaintiffs' reliance thereon. . . . Absent proof of negligence, we will not stand in willingness to impose a standard of strict liability on Midwest due to its issuance of the plaque." (App. p. A-16.) Of course, there is no question raised of strict liability. The question was whether there was misrepresentation and reliance thereon. Plaintiffs were precluded, by the summary judgment, from offering proof to a trier of fact of the respondent's "negligence" (to use the Court of Appeals term) or to show its failure "to enforce so far as within its powers

compliance by its members" (to use the statutary language of the 1934 Act).

The lower courts necessarily held that: (1) regardless of misrepresentation by respondent and reliance thereon by plaintiffs, plaintiffs cannot recover for the fraud perpetrated by Midwest's member, *and* (2) that an exchange need not, as a matter of law, undertake investigation of the character and behavior of its member whom it certifies to the public as a person of integrity and honesty. Only if this Court is prepared to endorse these rules should the lower court judgment be allowed to stand. Certainly such rules of law would, as suggested above, fly in the face of the purposes and function of the duties imposed on regulated exchanges by the Securities Exchange Act of 1934.

This Court has reiterated the governing rule with a frequency that should have compelled the courts below to recognize that, on a motion for summary judgment, theirs is not the role of fact-finder. This Court has, in many instances, reversed by short per curiam orders lower courts that undertake to decide on summary judgment questions of fact or inferences to be drawn from accepted facts. Thus, in *United States* v. *Diebold,* 369 U.S. 654 (1962), the Court summarily reversed, saying: "On summary judgment the inferences to be drawn from the underlying facts contained in such materials must be viewed in the light most favorable to the party opposing the motion." *Id.* at 655. In *Norfolk Monument Co.* v. *Memorial Gardens,* 394 U.S. 700 (1969), the Court granted certiorari and reversed in a single order, for similar reasons. In *Carter* v. *Stanton,* 405 U.S. 669 (1972), the Court again reversed, summarily admonishing the lower courts that they are not to serve as finders of facts in

disposing of motions for summary judgment. It may well be that such summary disposition is equally warranted here.

CONCLUSION

The judgment of the Court of Appeals either establishes a rule of law that totally exonerates stock exchanges from liability for the fraud of their members, so long as they choose not to know the facts of the misbehavior, or it resolves on summary judgment substantial questions of fact on which liability should not be predicated without opportunity for the petitioners to make their case before the jury. Thus, the judgment either plainly violates the intent and purposes of §6 of the Securities Exchange Act of 1934 or it plainly violates the commands of Rule 56 of the Federal Rules of Civil Procedure. In either event, it is incumbent on this Court to grant certiorari and reverse the erroneous rule of law established by the Seventh Circuit or to grant certiorari and reverse the judgment in order to remand the case for trial on the substantial issues of fact pretermitted by the Court of Appeals. In the latter event, the Court may choose to follow its own precedents by summary order calling for trial on the merits.

Respectfully submitted,

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APPENDIX

IN THE

UNITED STATES COURT OF APPEALS

FOR THE SEVENTH CIRCUIT

SEPTEMBER TERM, 1973 SEPTEMBER SESSION, 1973

Nos. 72-1977, 72-1978 OLGA HOCHFELDER, ET AL., *Plaintiffs-Appellants,* v. MIDWEST STOCK EXCHANGE, *Defendant-Appellee.*	Appeals from the United States District Court for the Northern District of Illinois, Eastern Division.
LEON S. MARTIN, ET AL., *Plaintiffs-Appellants,* v. MIDWEST STOCK EXCHANGE, *Defendant-Appellee.*	No. 71 C 454 No. 71 C 1204 THOMAS R. McMILLEN, *Judge.*

ARGUED SEPTEMBER 18, 1973 — DECIDED APRIL 10, 1974

Before SWYGERT, *Chief Judge*, CASTLE, *Senior Circuit Judge*, and SPRECHER, *Circuit Judge*.

SWYGERT, *Chief Judge*. This is an appeal by plaintiffs from a grant of summary judgment in favor of defendant, Midwest Stock Exchange. Plaintiffs are various individuals[1] who were victimized by a securities fraud perpe-

[1] The plaintiffs in appeal No. 72-1977, Olga Hochfelder, et al., filed an action on February 19, 1971 in district court against the Midwest Stock Exchange in the first count of the complaint, and against Ernst & Ernst, certified public accountants, in the second count. On May 18, 1971 a separate but identical complaint was filed by plaintiffs Leon S. Martin, et al., in appeal No. 72-1978. Midwest filed a motion for summary judgment applicable to both cases. By stipulation and subsequent order of the district court, the ruling in favor of Midwest in case No. 72-1977 was applied in case No. 72-1978. The appeals were consolidated by stipulation of the parties and our order of December 6, 1972.

trated by Leston B. Nay, President of First Securities Company of Chicago and owner of ninety-two percent of its stock. First Securities was registered with the Securities and Exchange Commission as a broker-dealer in securities and was a member of the Midwest Stock Exchange and the National Association of Securities Dealers, Inc. Each member organization in the Midwest Stock Exchange had a nominee or "member officer" who would represent the member organization for certain purposes, such as casting its vote in Midwest matters or trading on the Exchange floor. Nay was First Securities' member officer or nominee in the Midwest Stock Exchange, a position which he applied for and was admitted to in 1945.

The facts surrounding Nay's fraudulent scheme are set forth in detail in our opinion in *Securities & Exch. Com'n* v. *First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir. 1972), and need only be briefly restated. Plaintiffs were brokerage clients of First Securities, buying and selling securities through First Securities in regular fashion. Each plaintiff received investment advice from Nay, and each knew Nay to be the president of First Securities. Nay induced the plaintiffs to place funds in an "escrow" account which Nay represented would pay interest to plaintiffs at a high rate of return (generally twelve percent per annum, but later reduced to nine percent). Nay's fraudulent scheme came to light in 1968 as a result of a suicide note left by him describing First Securities as bankrupt due to his thefts and indicating that certain "escrow" accounts created by him were "spurious." Plaintiffs were among the investors in these spurious escrow accounts.

Nay's actions were violative of the federal securities laws and First Securities was derelict in fulfilling its duties pursuant to the Securities Exchange Act of 1934, 15 U.S.C. §78a, *et seq. Securities & Exch. Com'n* v. *First Securities Co. of Chicago*, 463 F.2d 981 (7th Cir. 1972). The thrust of plaintiffs' present action, asserting violations of the Securities Exchange Act of 1934, is that Midwest was negligent in scrutinizing Nay's application as a member officer and failed thereafter to adequately

investigate his continued fitness as a member, and as a result of its action and inaction Midwest aided and abetted Nay's violation of the 1934 Act.

In resolving whether summary judgment was correctly granted to Midwest we must first inquire whether there was a genuine issue of material fact as to the liability of Midwest. *Butterman* v. *Walston & Co.*, 387 F.2d 822 (7th Cir. 1967). The district court found there to be none and, as our opinion will demonstrate, we agree. Since no material facts are in dispute we must then make inquiry whether, on the basis of the uncontroverted facts, the district court correctly found as a matter of law that Midwest has incurred no liability under the Securities Exchange Act of 1934. The specific issues to be decided are: (1) whether Midwest fulfilled its duties as a national securities exchange under section 6 of the Securities Exchange Act of 1934; (2) whether Midwest aided and abetted by action or inaction any violation of Rule 10b-5 by Nay under the Securities Exchange Act of 1934; and (3) whether plaintiffs' claims against Midwest are barred by the statute of limitations. The district court determined these issues favorably to Midwest and granted summary judgment. We affirm.

I

It is plaintiffs' contention that Midwest inadequately scrutinized Nay's application in 1945 for the position of member officer or nominee of First Securities and as a result Nay was improperly admitted to membership in Midwest. Also, plaintiffs assert that various events and alleged violations of Midwest rules were sufficient to put Midwest on notice that Nay was no longer fit for membership and that Midwest's failure to inquire into these matters was a dereliction of duty. Plaintiffs claim that Midwest's alleged negligence in admitting Nay to membership and allowing him to continue as a member in the Exchange was a violation by Midwest of section 6(a)(1) of the Securities Exchange Act of 1934.

Midwest is a national securities exchange registered with the Securities and Exchange Commission pursuant to section 6 of the 1934 Act and accordingly must fulfill

the duties imposed under that section. Section 6(a)(1) provides that an exchange shall "enforce so far as is within its powers compliance by its members, with the provisions [of the 1934 Act and the rules and regulations thereunder]." Section 6(b) obligates the exchange to promulgate rules to "include provision for the expulsion, suspension, or disciplining of a member for conduct or proceeding inconsistent with just and equitable principles of trade," the violation of any provision of or rule under the 1934 Act being deemed conduct inconsistent with such principles. It is these provisions that prescribe in rather broad language the duties of self-regulation incumbent on Midwest as a registered exchange. With respect to the section 6 duty of self-regulation there are two inquiries which generally must be made: (1) the scope of the duties owed; and (2) whether the duties owed run to the plaintiffs.

At the outset we need not reach the question of whether the duties owed run to the plaintiffs for, assuming *arguendo* they do, we find that the duties owed were adequately fulfilled. Although the section 6 duty of self-regulation is framed in broad language, "to enforce so far as is within its powers", it is not a mandate of strict liability rendering the exchange a guarantor of all fraudulent schemes consummated by its members whether in listed or unlisted securities. To so read section 6 would tear at the very fabric of self-regulation, a burden which indeed no self-regulatory body could bear. The scope of the duty of self-regulation is not so far reaching. Rather, the scope must be delineated to include only those acts, events, schemes, or circumstances surrounding exchange members of which the exchange knows or has reasonable cause to know, or those events and circumstances which would reasonably put the exchange on notice, of a violation or suspected violation of a securities law, regulation or rule or, exchange rule.[2] It is only in the

[2] In *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (1944), a case of first impression, the Second Circuit held that the New York Stock Exchange had a duty "to investigate the dealings and the financial conditions of the members and to suspend or expel members who it had reason to believe had been guilty of conduct inconsistent with just and equitable principles of trade." 141 F.2d at 239. The test of liability articulated by the Second Circuit was proof that the Exchange had "knowledge or reasonable cause to suspect that [the Exchange member] was guilty of conduct inconsistent with just and equitable principles of trade. . . ." 141 F.2d at 243.

face of these circumstances that a failure to proceed with the requisite due care and conduct would be a dereliction of the duty of self-regulation. Measuring the duty of self-regulation to the present action, we find that Midwest, on the basis of the uncontroverted evidence in this case, did not fail to exercise the requisite care and conduct in admitting Nay to membership and allowing him to maintain his membership.

Plaintiffs assert that Midwest failed to exercise due care in reviewing Nay's application for membership in that: (1) Midwest did not discover Nay's change of his first name from Ladislas to Leston at the age of eighteen upon migration to the United States from Hungary; (2) Midwest did not investigate the circumstances surrounding the voluntary liquidation in 1942 of Webber, Darch & Company for whom Nay had been an officer and director; (3) Midwest made no inquiry of Halsey, Stuart & Company where Nay had been employed for the period 1921 through 1933; and (4) Midwest made no investigation into the circumstances surrounding Nay's prior two divorces. It is plaintiffs' contention that Midwest failed to exercise the requisite care in scrutinizing Nay's continued fitness to remain a member in view of alleged warnings of Nay's dubious integrity and desperate financial condition, namely: (1) Nay's insistence in 1949 on employing Joseph F. Hammel as a security salesman despite the fact that Midwest's investigation of Hammel produced evidence that Hammel had falsified his employment application; (2) Nay's request in 1959 of permission from Midwest to pledge his stock in First Securities for a personal loan; although Midwest denied Nay's request, it did not inquire into the reasons for Nay's request to pledge all his stock; (3) Midwest's awareness of the fact that First Securities had experienced a net capital

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[2] (Continued)

We have previously addressed ourselves to the test of liability applicable in determining whether an exchange satisfied the duty of self-regulation. In *Butterman* v. *Walston & Co.*, 387 F.2d 822 (7th Cir. 1967), *rehearing denied* (1968), *cert. denied*, 391 U.S. 913 (1968), we held the New York Stock Exchange not liable for a member firm's violation of the Exchange rules where it could be found that the Exchange "had no knowledge, or reasonable way of gaining knowledge, of alleged violations," and no duty to suspend or expel "until it had, or should have had, knowledge of violation or suspected violation." 387 F.2d at 825.

deficiency in late 1967 in violation of Midwest's rules; (4) Nay's borrowings from First Securities beginning in 1957; although Midwest approved of each borrowing, it did not investigate Nay's financial situation; and (5) Midwest's failure to request and examine copies of Nay's federal income tax returns which it is claimed would have demonstrated Nay's position of insolvency.

With respect to plaintiffs' charge of failure to appropriately screen Nay's application for membership, we find that the investigatory procedures employed by Midwest in 1944 were sufficient to satisfy the section 6 duty of self-regulation. Those procedures included among others letters of recommendation from banks and member organizations of Midwest; two sponsors of the applicant from member organizations appeared before the Admissions Committee of the Midwest Exchange to answer questions with respect to Nay's application; Nay appeared before the Admissions Committee and answered questions pertaining to his application; and a notice of Nay's proposed admission to the Exchange was sent to all members of Midwest requesting them to inform the Admissions Committee of any reason known to them which would indicate that Nay was unfit for membership in the Exchange.

We fail to find merit in plaintiffs' contention that Midwest should have investigated the circumstances surrounding Nay's change of first name and his divorces. These matters had no relevancy. Although Midwest did not inquire of Nay's one time employer, Halsey, Stuart & Company, and did not investigate further into the circumstances surrounding the voluntary liquidation of Webber, Darch & Company with whom Nay had been associated, in view of the admission procedures employed in 1945 it cannot be said that Midwest's failure to look into or pursue further these matters demonstrated a failure to exercise due care in scrutinizing Nay's application for membership.

Addressing ourselves to the issue of whether Midwest exercised due care in investigating Nay's continued fitness for membership, plaintiffs contend that various events and circumstances taking place between 1949 through April, 1968 should have put Midwest on notice that Nay no longer possessed the requisite character and moral integrity required of an Exchange member. It is also

contended that if Midwest had pursued these so-called warnings further, it would have discovered Nay's involvment in the fraudulent escrow scheme.

The first alleged warning of Nay's dubious integrity occurred in 1949 when Nay asked Midwest to reconsider his request for permission to employ Joseph F. Hammel as a security salesman even though Midwest's investigation of Hammel had uncovered evidence that Hammel had falsified his employment application. Although Nay offered to employ Hammel in a restrictive capacity, namely, dealing exclusively in transactions in municipal bonds with instutional clients, Midwest adhered to its denial of permission.

Plaintiffs argue that Nay's request of Midwest to reconsider Hammel's employment in a restrictive capacity should have put Midwest on notice of Nay's questionable integrity and suspect fitness for membership. We do not agree with this argument. Plaintiffs do not assert that Nay knew of Hammel's false statements prior to Midwest's investigation of Hammel nor do they contend that Nay's actions amounted to a violation of Exchange rules. In viewing this matter in hindsight, plaintiffs have placed undue importance on it.

Plaintiffs claim that in 1959, ten years after the employment incident, Midwest received its second warning of Nay's unfitness for membership, but failed to take appropriate action. Nay as ninety-two percent stock owner in First Securities requested permission from Midwest to pledge his stock holdings in First Securities for a personal loan he wished to obtain from a Chicago bank. Nay made his request pursuant to the Exchange rules. Although Midwest denied Nay permission to pledge his stock, plaintiffs maintain that the request should have put Midwest on notice that Nay was in serious financial straits and that, in any event, the request was of sufficient magnitude to put a burden of inquiry on Midwest to investigate Nay's personal reasons for such a loan. We are not convinced that Nay's request should have put Midwest on notice that Nay was in a financially desperate position. The request without additional facts was of a benign nature. Nor can we say that this request in conjunction with the employment incident ten years before was sufficient to put Midwest on notice of any wrongdoings or in

any way reflected unfavorably on Nay's fitness for membership. Plaintiffs assert that it was incumbent on Midwest to inquire into the reasons for the loan. Although we are cognizant of the magnitude of Nay's request, we are not prepared to place a burden of inquiry on an exchange which would effectively require scrutiny and investigation into all the personal affairs and activities of member nominees or the personal, business, and financial affairs of those individuals closely associated with member organizations. In this same vein plaintiffs contend that as part of the duty of self-regulation it was incumbent on Midwest to obtain and examine copies of Nay's federal income tax returns, which it is asserted would have uncovered Nay's fraudulent escrow scheme. As is true of the contention that Midwest should have investigated the reasons for Nay's personal loan, to require Midwest to inspect Nay's personal tax returns would impose a burden on Midwest to investigate into events not related to matters reflected in a member organization's books and records. Although Midwest used a protective system to assure responsibility and integrity in the handling of public customer business which focused primarily on the books and records reflecting the activities of member organizations,[3] plaintiffs argue that the system was insufficient because it failed to go beyond the member organization and investigate personal books and records, if any, reflecting the personal activities and affairs of member

[3] Midwest's rules provided that only corporations and partnerships could deal directly with the public. Accordingly, Midwest's surveillance program was directed towards member organizations and not the personal books and records of officers or employees of member firms.

The surveillance program imposed by Midwest was elaborate. Midwest's own staff periodically conducted a "field examination" which consisted of an examination and inspection of the books and records of member organizations. This was supplemented by interviews with personnel of the member firm. The written field examination program was in compliance with S.E.C. suggestions.

The Exchange rules required each member organization to submit to Midwest each year two audited financial questionnaires, one of which was to be certified by an independent public accountant selected and retained by the member organization. The audits were performed pursuant to S.E.C. Form X-17A-5, as amended from time to time by the S.E.C. In 1962 the annual certified audit was changed by Midwest to a surprise audit whereby the member organization would not know when the audit was scheduled to begin. The independent certified public accountant's audit would be reviewed by Midwest to verify compliance with the applicable rules. In addition the audit was required to include a review of the member organization's system of internal controls. Midwest would conduct its field examination at a time other than the fiscal period for which the surprise audit was made.

nominees. This asserted burden of inquiry would be applicable not solely to those individuals similarly situated to Nay; rather, the burden of inquiry would likewise be applicable to everyone associated with any member organization who might possibly be engaged in a personal, remote, and carefully concealed fraudulent scheme. To place such a burden on Midwest to inquire into affairs unrelated to the activities of the Exchange would be tantamount to making the Exchange a guarantor of losses resulting from every fraudulent, personal scheme engaged in by individuals associated with member organizations. Indeed, the implementation of such a burden of inquiry might well be counter-productive in that it would dissipate resources which are limited and needed for the basic self-regulatory actions in scrutinizing matters pertaining to member organization activities and affairs.

Plaintiffs next contend that a series of loans made by First Securities to Nay from 1957 to 1968 should have put Midwest on notice of Nay's precarious financial condition and asserted unfitness for Midwest membership. Nay borrowed money from First Securities during this eleven year span and pursuant to Exchange rules notified Midwest of the borrowings. The frequency of the borrowings and the total amount of the borrowings were not of such an unusual nature so as to put Midwest on notice of any wrongdoing by Nay.[4] Nor can it be said that the combined events—the employment incident, the request to pledge stock, and the continuous borrowings—were sufficient to put Midwest on notice that Nay was no longer fit to continue as a member of the Midwest Stock Exchange.

The final event which plaintiffs assert reflected unfavorably on Nay's integrity concerned the circumstances surrounding First Securities' temporary net capital deficiency in October, 1967.[5] In the course of its routine

[4] As of November 30, 1967 Nay had borrowed $74,500 from First Securities as compared to his share of the net worth in the corporation of approximately $120,000.

[5] The "net capital rules" of the various exchanges and of the S.E.C. require that a broker-dealer's "aggregate indebtedness" must never be more than a specified percentage of its net capital. The "net capital" reflects the liquidity of the broker-dealer and is a conservative figure which is in general substantially less than "net worth." *See, e.g., Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), pt. 1, ch. III, p. 407.

analysis of First Securities' September 30, 1967 financial questionnaire, Midwest determined that First Securities was not in compliance with the net capital rules of the Exchange. Immediate action was taken and First Securities was advised on October 27 of the deficiency and requested to take appropriate steps to rectify the situation. First Securities was also warned that a failure to cure the situation within a reasonable time could lead to its suspension from the Exchange. On November 3 Nay informed the Exchange that First Securities had a net capital deficiency of $9,332 as of October 31, 1967. Nay also indicated that First Securities' independent certified public accountant, Ernst & Ernst, was engaging in a surprise audit pursuant to Exchange rules of the financial period ending October 31, 1967 and that the net capital deficiency would be appropriately explained. Ten days later Nay notified Midwest that he had reduced his indebtedness to First Securities thereby restoring First Securities to full compliance with the Exchange's net capital requirements as of October 31, 1967. On December 6, 1967 in response to an inquiry by Ernst & Ernst, Midwest indicated that the October 31, 1967 financial questionnaire prepared by Ernst & Ernst on the basis of its surprise audit need not reflect the temporary net capital deficiency since it had been corrected in early November by Nay's reduction of his indebtedness to First Securities. On that same day Midwest advised Nay that First Securities' November 30, 1967 financial questionaire indicated a net capital excess of $22,000 and that therefore Nay would be granted permission to borrow $10,000 from First Securities.

Plaintiffs contend that Midwest encouraged Ernst & Ernst to make a material omission on the October 31, 1967 questionnaire which was to be submitted to Midwest and that Midwest sanctioned a mere token repayment of $10,000 since Nay was allowed to borrow $10,000 from First Securities in early December. Plaintiffs charge that these events were sufficient to place a duty on Midwest to investigate Nay and, presumably, his personal financial affairs and continued fitness for Midwest membership. Because of the nature of the financial questionnaire and the fact it was prepared for Midwest's usage, we need not indulge in a technical analysis of whether it accurately depicted First Securities' financial position as of October 31, 1967, nor are we convinced that Nay's sub-

sequent borrowing rendered the earlier repayment meaningless. Indeed, the evidence indicates that Midwest was alert in discovering the deficiency and took immediate steps to have it corrected. Viewing this event with all the other asserted warnings, we are not convinced that *in toto* they were sufficient to put Midwest on notice that further inquiry was warranted.

Having examined the asserted warnings and Midwest's response thereto, we find that as a matter of law the warnings do not demonstrate a lack of due care in scrutinizing Nay's continued fitness for membership in Midwest. Accordingly, we hold that Midwest satisfied its duty of self-regulation.

Moreover, even assuming that Midwest breached its duty of self-regulation in that the net capital deficiency discovered in October, 1967 was, either by itself or in combination with the prior events, sufficient to put Midwest on notice that Nay was engaging in fraudulent conduct and no longer qualified for membership in the Exchange, plaintiffs are confronted with yet another obstacle which they cannot overcome, namely, a lack of causal connection.

In *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 323 U.S. 787 (1944), the Second Circuit, in fashioning a duty of self-regulation under section 6, held that an essential element of liability grounded on a section 6 violation was proof of a causal connection between an exchange's breach of duty and the plaintiffs' asserted losses; further, that the plaintiffs had the burden of proving causation. Recognizing that the defendant stock exchange had breached its duty of self-regulation the court went on to find that the plaintiffs had failed to prove causation:

> We accede to the view that the Stock Exchange violated a duty when it failed to take disciplinary action against Richard Whitney on November 24, 1937, after there was reason to believe that the latter had converted the plaintiffs' securities. But to justify a judgment in favor of either plaintiff, such a breach of duty must have resulted in damage that can be traced to the breach . . . . In the case of the Exchange there was no duty except to investigate the dealings and the financial conditions of the members and to

> suspend or expel members who it had reason to believe had been guilty of conduct inconsistent with just and equitable principles of trade. It appears from the record that by reason of unauthorized pledges the securities had all been converted prior to November 24, 1937, and were then in the possession of pledgee banks and so remained for some time thereafter, though at certain times all of them were returned to the pledgor and during the same day repledged to secure other loans. We can see no likelihood that the expulsion or suspension of Richard Whitney when his conversions came to the notice of the officers of the Exchange on November 24, 1937, would have in the least benefited the plaintiffs for the securities were then all converted and in the hands of pledgees. 141 F.2d at 239.

Assuming Midwest's failure to act in late 1967 amounted to a breach of duty, it would nevertheless appear to be of no consequence to plaintiffs' losses. Plaintiffs had departed with their money many years prior to 1967. Some of the escrow transactions were entered into as early as 1942 with the bulk of the transactions being completed in the 1950's and the last escrow transaction consummated in 1966. Plaintiffs admit that by 1967 Nay was hopelessly insolvent and apparently he possessed no substantial assets. Even if Midwest had satisfied its duty of self-regulation, assuming a derelection, it would have been of no avail to plaintiffs. At that time their losses could not have been avoided in whole or part. Accordingly, there is no proof available, to show a causal connection between plaintiffs' losses and the asserted breach of duty in late 1967.

II

Plaintiffs contend that pursuant to section 6 of the Securities Exchange Act of 1934 Midwest had a duty to enforce Rule 27(c) of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. In *Securities & Exch. Com'n* v. *First Securities Co. of Chicago,* 463 F.2d 981 (7th Cir. 1972), *cert. denied,* 409 U.S. 880 (1972), we held First Securities, a member of the N.A.S.D., liable for Nay's fraud, due to its failure

to enforce Rule 27.[6] As a member of the N.A.S.D. it was incumbent on First Securities to enforce the N.A.S.D. rules. In this action plaintiffs request that we place a duty on Midwest as a national securities exchange to enforce the rules of another self-regulatory organization, namely, the N.A.S.D., a national securities association. Without facing the question whether even the N.A.S.D. as promulgator of Rule 27 could be liable because of its member's noncompliance, plaintiffs would have us place an additional burden on Midwest to enforce the rules of another self-regulatory body. There is nothing in the 1934 Act which mandates this unique theory. Indeed, the imposition of such a burden of enforcement would be unduly onerous and result in a wasteful duplication of actions in that Midwest would be expected to enforce the rules of all self-regulatory organizations to which a member firm might belong. This would be contrary to the avowed intention of Congress and the Securities and Exchange Commission that there be more coordination and less duplication of self-regulatory activities.[7] We hold that

[6] Rule 27 in pertinent part provides:

(a) Each member [of the Association] shall establish, maintain and enforce written procedures which will enable it to supervise properly the activities of each registered representative and associated person to assure compliance with applicable securities laws, rules, regulations and statements of policy promulgated thereunder and with the rules of this Association.

(b) Final responsibility for proper supervision shall rest with the member . . . .

(c) Each member shall be responsible for keeping and preserving appropriate records for carrying out the member's supervisory procedures. Each member shall review and endorse in writing, on an internal record, all transactions and all correspondence of its registered representatives pertaining to the solicitation or execution of any securities transaction

Nay had forbidden anyone other than himself to open mail addressed to him, and in his absence all such mail was allowed to accumulate on his desk, even if it was addressed to First Securities for his attention. This rule facilitated and fostered Nay's perpetration of the escrow fraud. As a result, we held that First Securities' enforcement of Nay's practice regarding the opening of mail was sufficient on its face to constitute a violation of Rule 27. 463 F.2d at 988.

[7] To impose such a wide-ranging duty of enforcement would be in direct opposition to the recommendation in the *Report of the Special Study of Securities Markets of the Securities and Exchange Commission* to improve efficiency and economy of the total regulatory effort by avoiding duplication:

This report indicates various ways in which the quantity and quality of self-regulation and/or governmental regulation need strengthening. On the other hand, available mechanisms, budgets, and personnel of some agencies already seem overtaxed, and at the same time there appears to be considerable duplication of effort . . . .

Midwest was under no duty to inforce Rule 27(c) of the Rules of Fair Practice of the N.A.S.D.

III

Plaintiffs claim that in view of the alleged warnings of Nay's desperate financial condition and dubious integrity, Midwest's action or inaction amounted to aiding and abetting Nay's violation of Rule 10b-5. The charge of aiding and abetting is grounded on two contentions: Midwest aided and abetted solely by inaction; Midwest's affirmative action of issuing Nay a Midwest membership wall plaque was of itself or in combination with Midwest's omission to act sufficient to make out a claim of aiding and abetting a Rule 10b-5 violation.

Confronting the charge of aiding and abetting solely by inaction we note that it is well established that one may aid and abet by inaction in combination with affirmative action. *See Brennan* v. *Midwestern United Life Insurance Co.*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970); *Buttrey* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 410 F.2d 135 (7th Cir. 1969), *cert. denied*, 396 U.S. 838 (1969). However, in those cases where we have stated that one may aid and abet solely by inaction, we reached a finding of liability on the basis

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[7] (Continued)

In the interests of the public, the regulatory agencies and the securities industry, further and continuing attention should be given to possibilities for coordinating efforts and allocating responsibilities in a more efficient and productive pattern . . . . *Report of the Special Study of Securities Markets of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963), pt. 4, ch. III, p. 738.

Congress followed this approach to effective self-regulation through clear division of labor among self-regulatory bodies when it enacted the Securities Investor Protection Act of 1970, 15 U.S.C. § 78aaa, *et seq.* In section 9(c), 15 U.S.C. § 78iii(c), Congress provided that where a member of the Securities Investor Protection Corporation, the S.I.P.C., whose membership includes nearly all broker-dealers, is a member of more than one self-regulatory organization, the S.I.P.C. shall designate one of such organizations to inspect or examine the S.I.P.C. member "for compliance with applicable financial responsibility rules." The goal "that more coordination is needed for planning, for surveillance, and for elimination of duplication" was recently reaffirmed by the House Subcommittee on Commerce and Finance. *Securities Industry Study of the Subcommittee on Commerce and Finance of the Committee on Interstate and Foreign Commerce*, H.R.Rep. No. 92-1519, 92nd Cong., 2d Sess. 115 (1972). The imposition of the burden of enforcement advocated by plaintiffs would indeed be a major obstacle to attaining the goal of coordination of efforts and elimination of duplicative waste.

of affirmative action in combination with inaction. *See, e.g., Brennan* v. *Midwestern Life Ins. Co.*, 259 F.Supp. 673 (N.D. Ind. 1966); *Anderson* v. *Francis I. DuPont & Co.*, 291 F.Supp. 705 (D. Minn. 1968). Indeed, in the only case where it may fairly be stated that the court was faced with a claim of aiding and abetting solely by inaction, the Ninth Circuit declined to accept such a theory of Rule 10b-5 liability stating:

> There is not a scrap of authority supporting this extraordinary theory of Rule 10b-5 liability, and we will not supply any in this case.
>
> We find nothing in Rule 10b-5 that purports to impose liability on anyone whose conduct consists solely of inaction . . . . We perceive no reason, consonant with the congressional purpose in enacting the Securities and Exchange Act of 1934, thus to expand Rule 10b-5, liability (*Cf.* SEC v. Texas Gulf Sulphur Co., *supra*, 401 F.2d at 866-868 (J. Friendly, concurring specially).) On the contrary, the exposure of independent accountants and others to such vistas of liability, limited only by the ingenuity of investors and their counsel, would lead to serious mischief. *Wessel* v. *Buhler*, 437 F.2d 279, 283 (9th Cir. 1971).

Keeping in mind the frequent admonition of the Supreme Court that courts must be alert to provide such remedies for securities frauds as to make effective the Securities Acts, *SEC* v. *Capital Gains Bureau*, 375 U.S. 180, 195 (1963); *Tcherepnin* v. *Knight*, 389 U.S. 332, 336 (1967); *Mills* v. *Electric Auto-Lite Co.*, 396 U.S. 375, 386 (1970), we are not prepared to hold that a claim for aiding and abetting solely by inaction cannot be made under Rule 10b-5. In invoking such a rule, however, we would not go so far as to charge a party with aiding and abetting who somehow unwittingly facilitated the wrongful acts of another. Rather, to invoke such a rule investors must show that the party charged with aiding and abetting had knowledge of or, but for a breach of duty of inquiry, should have had knowledge of the fraud, and that possessing such knowledge the party failed to act due to an improper motive or breach of a duty of disclosure. Plaintiffs do not and could not contend that Midwest had actual knowledge of Nay's fraudulent escrow scheme. And, as our analysis

of Midwest's section 6 duty of self-regulation demonstrates, Midwest adequately satisfied its duty of inquiry and had no reason to know of or suspect Nay's fraudulent escrow scheme. Failing proof that Midwest knew or should have known of Nay's fraud we need not further our inquiry into the other elements of a claim for aiding and abetting solely by inaction.

We turn then to plaintiffs' contention that Midwest aided and abetted by affirmative action in that it negligently issued and allowed Nay to maintain a Midwest membership plaque which plaintiffs assert they relied on in making their investments in the spurious escrow account. Plaintiffs expend considerable efforts in arguing that the plaque was a representation or certification of Nay's integrity in all financial matters and that plaintiffs reasonably relied on this representation in participating in the escrow scheme.[8] We do not reach the question of the scope of Midwest's representation through the medium of the plaque or the reasonableness of plaintiffs' reliance thereon. Rather, we find that having fulfilled its section 6 duty of self-regulation, it cannot be said that Midwest was negligent in issuing and allowing Nay to maintain the plaque. Absent proof of negligence, we will not stand in willingness to impose a standard of strict liability on Midwest due to its issuance of the plaque. Accordingly, we hold plaintiffs' charge of aiding and abetting through the affirmative action of issuing a plaque to be without merit.

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[8] The plaque contained the following language:

MIDWEST STOCK EXCHANGE

Organized 1882

An Association for Brokers, Whose Object is to Establish and Conduct a Market for Listed Securities, where High Standards of Commercial Honor and Integrity are maintained and Just and Equitable Principles of Trade and Business prevail.

LESTON B. NAY

of

First Securities Company of Chicago

/s/ Carl E. Ogren, *Secretary* — /s/ James E. Day, *President*

(This Certificate is the Property of Midwest Stock Exchange).

IV

The district court held that the appropriate statute of limitations had run prior to the filing of this action in February, 1971. Plaintiffs contended that the equitable tolling doctrine prevented the statute from beginning to run until Nay's fraud was discovered in 1968 at the time of his suicide. If plaintiffs' invocation of the equitable tolling doctrine had been allowed it is clear that their respective actions would have been timely filed. In rejecting plaintiffs' contention, the district court held, "To toll the statute, the defendant must have actively concealed the cause of action, and Midwest clearly was not shown to have done this." *Hochfelder* v. *Midwest Stock Exchange*, 350 F.Supp. 1122, 1125 (N.D. Ill. 1972). The equitable tolling doctrine provides that where a fraud which is the foundation of the suit has actively been concealed or is of such a nature as to conceal itself, the statute of limitations is tolled until the plaintiff has obtained knowledge of the fraud or in the exercise of due care should have obtained knowledge of the fraud. *Bailey* v. *Glover*, 88 U.S. (21 Wall.) 342, 349 (1874); *Holmberg* v. *Armbrecht*, 327 U.S. 392, 396 (1945); *Morgan* v. *Koch*, 419 F.2d 993, 997 (7th Cir. 1969). The gravamen of plaintiffs' action against Midwest is admittedly grounded in negligence, and is not grounded on any contention that Midwest is chargeable with affirmative acts of fraud or fraudulent concealment. However, we do not believe that the tolling doctrine should be so narrowly drawn that it does not encompass Midwest's alleged acts of facilitation of the fraud.

It is charged that Midwest's conduct amounted to negligence and that its negligence facilitated or provided the means for Nay's fraud. Nay effectively concealed his fraud and as a result the alleged implementing negligence of Midwest was concealed and brought to the surface only when the facts surrounding Nay's fraud were first discovered. If claims brought in the same posture as the instant action—asserting charges amounting to negligence but short of fraud—are to have any vitality, it cannot be contended that the tolling doctrine should not apply. Often the underlying fraud, carefully concealed in and of itself, would cloak the implementing actions of others. Accord-

ingly, where the acts of a defendant facilitate the perpetration of a concealed fraud of another, the bar of the statute of limitations should not begin to run until a plaintiff obtains knowledge or through due diligence should have obtained knowledge of the underlying fraud. In view of our holding on the merits of plaintiffs' claims, however, we need not otherwise further our inquiry with respect to the litigants' contentions regarding the statute of limitations.

On the basis of the foregoing the judgments of the district court are affirmed.

SUPREME COURT, U. S.

JUL 2 1974

MICHAEL RODAK, JR., CLERK

IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1973

No. 73-1828

OLGA HOCHFELDER, et al.,

Petitioners,

vs.

MIDWEST STOCK EXCHANGE,

Respondent,

LEON S. MARTIN, et al.,

Petitioners,

vs.

MIDWEST STOCK EXCHANGE,

Respondent.

RESPONDENT'S BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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OPINIONS BELOW

The opinion of the District Court is officially reported at 350 F.Supp. 1122 and is reproduced in the appendix hereto. The opinion of the Court of Appeals has not been officially reported. It has been unofficially reported at CCH Fed. Sec. L. Rep. ¶94,499 [Current Binder] and appears in the appendix to the petition herein.

JURISDICTION

The judgment of the Court of Appeals was entered on April 10, 1974. No petition for rehearing was filed. The jurisdiction of this Court is properly invoked under 28 U.S.C. § 1254(1) and jurisdiction in the courts below was properly invoked under 15 U.S.C. § 78aa.

QUESTION PRESENTED

Whether the Court of Appeals correctly ruled, on the undisputed facts, that as a matter of law respondent Midwest Stock Exchange fulfilled its responsibilities to plaintiffs under Section 6 of the Securities Exchange Act of 1934.

STATEMENT

Petitioners brought suit against the Midwest Stock Exchange (sometimes hereinafter referred to as "Midwest") contending that Midwest was liable to them in connection with an alleged fraud perpetrated by an officer of a member organization of Midwest. Midwest moved for summary judgment and supplied extensive affidavits in support of its contention that it had no knowledge of the fraud and as a matter of law it had discharged whatever duties it may have owed petitioners. Both the District Court and the Court of Appeals held that the record did not raise any genuine issue of a material fact and summary judgment was granted in favor of Midwest. The facts before both courts included the following.

Midwest and predecessors* were, at all times material to these actions, national securities exchanges registered with the Securities and Exchange Commission ("SEC")

* All references to Midwest prior to 1949 refer to the Chicago Stock Exchange. Midwest was formed in 1949 through a merger of the Chicago and other stock exchanges.

pursuant to Section 6 of the Securities Exchange Act of 1934 ("1934 Act"), 15 U.S.C. § 78f. First Securities Company of Chicago ("First Securities"), with Leston B. Nay as president, was first approved for membership in Midwest in 1944. In November, 1945, Nay applied to be the nominee of First Securities. (Each member organization of Midwest had a nominee, who was the individual representing the member organization for certain purposes, such as casting its vote in Midwest matters or trading on the exchange floor.) The change in nominee required a reapplication for membership by First Securities. All the necessary papers were filed in proper form by Nay and by First Securities, including letters of recommendation from banks and members of Midwest. A hearing was held on Nay's application before the Admissions Committee and Nay appeared to answer questions.

After the Admissions Committee unanimously recommended that Nay be admitted to membership as nominee of First Securities, the notice of the proposed transfer to Nay from the prior nominee was posted on Midwest's trading floor and mailed to all members. The notice stated the duty of all members to inform the secretary of Midwest "of any reason known to them why [Nay] would not make a desirable member of the Exchange." Although Nay had worked in Chicago's financial community for nearly twenty-five years, no one communicated any unfavorable information to Midwest.* In December of 1945 Nay's application was unanimously approved by the Executive Committee of Midwest. Nay, as nominee of First Securities, was then issued a certificate, the post-1949 version of which is set forth at page 5 of the petition herein.

* Petitioners have apparently dropped the claim, urged vigorously below, that one reason Midwest's admissions process was deficient was that it did not investigate Nay's change of his first name upon his migration to the United States in 1921 or the circumstances of his divorces in 1925 and 1935. (Pet., p. A6)

Over the years Nay's conduct was, as far as Midwest knew, in full accord with the requirements of the 1934 Act, the rules of the SEC and the rules of Midwest. Although Nay's personal books and records were not examined,* First Securities (including, of course, Nay's business conducted through First Securities) was at all times subject to thorough surveillance by Midwest. For example, Midwest's own personnel periodically conducted a "field examination" which consisted of an examination and inspection of the books and records of the member organization. This was supplemented by interviews with personnel of the member firm. Prior to its first use in 1956, the written field examination program was submitted to the SEC for its comments.

Each member organization was also required to submit to Midwest each year two audited financial questionnaires, one of which was to be certified by an independent public accountant selected by the member organization and approved by Midwest. The audits were conducted pursuant to SEC Form X-17A-5, as amended from time to time by the SEC. The audit submitted by the accountant would then be reviewed by Midwest to verify compliance with applicable rules, including Midwest's net capital requirements.**

Ernst & Ernst, the independent auditors for First Securities, annually submitted the audited financial questionnaires of First Securities to Midwest as required by its rules. Midwest relied upon Ernst & Ernst to conduct the audits

* Midwest's surveillance program did not involve examination of personal books and records of officers or employees of member organizations because, under its rules, all business with the public was required to be conducted by member organizations or partnerships, as distinguished from individuals.

** In late 1967, shortly before Nay's suicide, Midwest determined from a review of a routine financial questionnaire submitted to it by First Securities that First Securities had a small net capital deficiency. First Securities was quickly brought into compliance with Midwest's net capital requirements.

of First Securities in accordance with applicable rules and regulations of Midwest and the SEC, as well as generally accepted auditing standards. The audits conducted by Ernst & Ernst were required to and did include a review of First Securities' internal controls.

Unbeknown to Midwest or to any other regulatory or self-regulatory body, beginning in 1942 Nay began a fraud in the nature of a "Ponzi" scheme.* Nay allegedly induced petitioners herein to place funds in a fictitious "escrow" account which he represented would pay interest to them at 9% or, in some cases, 12% per annum at a time when the prevailing rate was less than 4%. Nay allegedly converted to his own use the money placed with him and upon his suicide in June, 1968 no funds remained in the "escrow."

The "escrow" transactions between petitioners and Nay were clearly personal, for the following reasons among others. Interest payments were made directly by Nay to petitioners and, as they knew, Nay claimed those payments as deductions on his personal federal tax returns. The transactions were not conducted through First Securities and no aspect of the "escrow" transactions was shown on the books and records of First Securities. In particular, the "escrow" transactions were never reflected on petitioners' periodic statements received from First Securities.

Despite the extensive examination and auditing requirements applicable to member firms, neither Midwest nor Ernst & Ernst uncovered the personal "escrow" scheme, nor did any petitioner or anyone else bring it to the attention of Midwest. It is undisputed that at no time until Nay's suicide did anyone at Midwest know of the "escrow" scheme.

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* *Cunningham* v. *Brown*, 265 U.S. 1 (1924).

These two actions brought against Midwest were filed in February and May of 1971, respectively. The District Court rendered a summary judgment for Midwest in both cases in October, 1972. Petitioners have never asserted that they did not have ample opportunity to conduct discovery to develop facts in opposition to the facts set forth in the affidavits filed by Midwest in support of its motion. The District Court stated:

> The facts insofar as Midwest's defenses are concerned are contained in several affidavits filed with its motion demonstrating its relationship to Nay and First Securities. These facts are not controverted by counter-affidavits. The remaining question, therefore, is whether any genuine issues of material fact exists [sic] between the parties to this litigation. We believe there are none and that the only issues remaining to be decided are issues of law. (350 F.Supp. 1122, 1124; App., p. A2)

Likewise, the Court of Appeals stated:

> The district court found there to be [no genuine] issues of material fact and, as our opinion will demonstrate, we agree. Since no material facts are in dispute we must then make inquiry whether, on the basis of the uncontroverted facts, the district court correctly found as a matter of law that Midwest has incurred no liability under the Securities Exchange Act of 1934. (Pet., p. A3)

Both courts then concluded that, as a matter of law, on the undisputed facts, Midwest had discharged whatever responsibilities it owed petitioners in connection with Nay's personal Ponzi scheme.

ARGUMENT

Much of petitioners' argument relates to their contention that they were not given an opportunity to establish before a jury that respondent did not discharge its responsibilities to them under Section 6 of the 1934 Act.* It is important to note that petitioners do not contend that they were deprived of any opportunity to engage in discovery or to present facts in opposition to respondent's affidavits. Since petitioners had ample opportunity to do both but offered no evidence to controvert respondent's affidavits, it can only be assumed that they had none. Thus petitioners' claim that they were deprived of an opportunity to present their case to a jury has no substance.

In the absence of evidence contrary to that supplied by respondent, the courts below correctly concluded that there was no genuine issue of a material fact and the only questions presented were ones of law. Petitioners take issue with the standard of duty applied to respondent by the Court of Appeals, but their position is based upon a misreading of that opinion. When the opinion is properly read, it is apparent that the Court of Appeals rendered a decision which is consistent with decisions in other circuits, with the policy behind the concept of self-regulation embodied in the 1934 Act and with the undisputed facts of this case.

---

* In the courts below petitioners also contended that respondent was liable to petitioners for aiding and abetting Nay's alleged violation of Rule 10b-5 (17 CFR 240.10b-5), promulgated by the SEC pursuant to Section 10(b) of the 1934 Act (15 U.S.C. § 78j(b)), and for not having enforced Rule 27 of Article III of the Rules of Fair Practice of the National Association of Securities Dealers, Inc. Except for a passing reference to aiding and abetting, petitioners appear to have dropped those claims. Therefore, respondent will not state the reasons why the decision below was correct in those respects. Since the one theory of liability which petitioners now urge is based upon respondent's status as a national securities exchange, petitioners are not correct when they assert that the grounds for respondent's liability are "similar" to those asserted against First Securities itself in the case cited by petitioners. (Pet., p. 4)

I.

THE DECISION BELOW IS CLEARLY CORRECT AND WAS DECIDED IN ACCORDANCE WITH ESTABLISHED PRINCIPLES OF LAW.

In reaching the conclusion that respondent had met its responsibilities as a self-regulatory organization under the 1934 Act the Court of Appeals followed established precedent. It relied on its own decision in *Butterman* v. *Walston & Co.*, 387 F.2d 822 (7th Cir. 1967), *cert. denied*, 391 U.S. 913 (1968), and the time-honored decision in *Baird* v. *Franklin*, 141 F.2d 238 (2d Cir. 1944), *cert. denied*, 323 U.S. 737 (1944). These cases have been followed consistently. *Hughes* v. *Dempsey-Tegeler & Co., Inc.*, CCH Fed. Sec. L. Rep. ¶94,133 (C.D. Cal. 1973) [1973 Transfer Binder]; *Marbury Management, Inc.* v. *Alfred Kohn, Wood, Walker & Co.*, 373 F.Supp. 140 (S.D.N.Y. 1974), following the District Court opinion in the instant cases; *Caddell* v. *Goodbody & Co.*, CCH Fed. Sec. L. Rep. ¶ 93,938 (N.D.Ala. 1972) [1973 Transfer Binder]; and *Steinberg* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, CCH Fed. Sec. L. Rep. ¶ 94,599 (S.D. N.Y. 1974) [Current Binder]. These cases all stand for the proposition that an exchange has a duty to act only when it has knowledge of wrongful conduct by a member organization or reasonably should have had such knowledge under all the circumstances. In this case the undisputed facts established that respondent had no knowledge of Nay's fraud and nothing which came to respondent's attention merited more inquiry than was in fact made.

The court below held that the Section 6 duty of self-regulation

> is not a mandate of strict liability rendering the exchange a guarantor of all fraudulent schemes consummated by its members whether in listed or unlisted securities. To so read section 6 would tear at the very fabric of self-regulation, a burden which indeed no self-regulatory body could bear. The scope of the duty

> of self-regulation is not so far reaching. Rather, the scope must be delineated to include only those acts, events, schemes, or circumstances surrounding exchange members of which the exchange knows or has reasonable cause to know, or those events and circumstances which would reasonably put the exchange on notice, of a violation or suspected violation of a securities law, regulation or rule, or exchange rule. (Pet., p. A4; footnote omitted.)

The District Court similarly observed that the surveillance program of a securities exchange need not be "fluoroscopic." (350 F.Supp. at 1125; App., p. A4).

The standard so eloquently phrased by both courts below is in accordance with the provisions of Section 6 which requires only that a registered securities exchange agree

> to comply, and to enforce *so far as is within its powers* compliance by its members, with the provisions of [the 1934 Act], and any amendment thereto and any rule or regulation made or to be made thereunder. Section 6(a)(1), U.S.C. § 78f(a)(1). (Emphasis added)

The plain and only realistic meaning of this provision, as recognized by the courts below, is that an exchange undertakes to do whatever is reasonable in the circumstances, consistent with its role in the total regulatory structure and its other self-regulatory responsibilities. Unless so read, Section 6 would render an exchange an insurer of the conduct of every member and every individual connected with a member.

Applying the foregoing standard to the undisputed factual record, the Court of Appeals concluded, as a matter of law, that respondent had met its responsibilities under the 1934 Act, and that the facts which came to its attention in the course of its extensive program of surveillance did not require any further action on its part. (Pet., pp. A5-11)

Petitioners have done nothing more than grasp at a few isolated occurrences over a twenty-five year period which they contend should have alerted respondent to investigate Nay further, to probe into his personal life and to examine his tax returns. The Court of Appeals held that none of these incidents standing alone, nor all together, merited the kind of sweeping inquiry suggested by petitioners. (Pet., p. A11)

Petitioners' challenge to the decision below appears to be based on a misreading of the opinion. For example, petitioners suggest that the Court of Appeals established a rule of law permitting Midwest to escape liability by choosing "not to know" the facts of the alleged misbehavior. (Pet., p. 13) The Court of Appeals' actual holding was that Midwest in exercising its duty of self-regulation "did not fail to exercise the requisite care and conduct in admitting Nay to membership and allowing him to maintain his membership." (Pet., A5) Respondent did what was reasonably required of it under the 1934 Act and, having done so, it could not be held responsible to petitioners for Nay's fraud. The Court of Appeals held:

> [W]e are not prepared to place a burden of inquiry on an exchange which would effectively require scrutiny and investigation into all the personal affairs and activities of member nominees or the personal, business, and financial affairs of those individuals closely associated with member organizations. (Pet., p. A8)
>
> • • •
>
> . . . To place such a burden on Midwest to inquire into affairs unrelated to the activities of the Exchange would be tantamount to making the Exchange a guarantor of losses resulting from every fraudulent, personal scheme engaged in by individuals associated with member organizations. Indeed, the implementation of such a burden of inquiry might well be counterproductive in that it would dissipate resources which

> are limited and needed for the basic self-regulatory actions in scrutinizing matters pertaining to member organization activities and affairs. (Pet., p. A9)

The Court of Appeals did not say that Midwest had no burden of investigation or surveillance as petitioners contend. (Pet., p. 8) It held that Midwest did have such a responsibility and that it had discharged it through the field examination program and audit requirement and otherwise.

Plaintiffs contend that the decision below precluded them from offering evidence of their reliance on the membership certificate issued by respondent. (Pet., p. 11) First, any lack of evidence on reliance was not due to any action by the District Court but rather to petitioners' failure to adduce such proof. More important, since respondent was held not culpable, reliance *vel non* by the petitioners was properly held to be irrelevant. (Pet., p. A16) As in any case, if a defendant can establish as a matter of law that a necessary element of the plaintiff's case cannot be proven (here, dereliction of duty), it is irrelevant to the ultimate decision whether or not the plaintiff could prove the other elements of his case (here, reliance).

Stripped to its essentials, the petition asks this Court to review the factual record and determine whether there were genuine issues of material fact, contrary to the conclusion reached by both courts below. Petitioners are thus asking this Court to do that which it eschews as a matter of policy. *Southern Power Co.* v. *North Carolina Public Service Co.*, 263 U.S. 508, 509 (1924); *Rudolph* v. *United States*, 370 U.S. 269, 270 (1962). Such a factual inquiry is especially unnecessary where both courts below have reached the same conclusion and petitioners themselves offered no facts to controvert respondent's affidavits.*

* Petitioners' request for this Court to review the factual record in these circumstances is particularly inappropriate since their

II.

THERE ARE ALTERNATIVE, INDEPENDENT GROUNDS IN SUPPORT OF THE DECISION BELOW

Petitioners contend that the Court of Appeals erred in holding that respondent had discharged its self-regulatory duties as a matter of law. As shown above, this holding was correct. However, even if this Court were to grant the petition and ultimately remand these cases for a trial on that issue, the judgment below for respondent could be reached on other grounds as a matter of law. Where there are such alternative grounds for reaching the same result below, it is inappropriate for this Court to grant certiorari on the one ground presented. *The Monrosa* v. *Carbon Black Export, Inc.*, 359 U.S. 180, 183-184 (1959) and cases cited.

First, there was no causal connection between respondent's alleged failure to act and petitioners' losses; in particular, the Court of Appeals held that as a matter of law there was no causal connection between the alleged dereliction by Midwest relating to First Securities' net capital deficiency in late 1967 and petitioners' losses. (Pet., pp. A11-12)

Second, respondent contended below that the petitioners' claims were barred by the statute of limitations. The District Court agreed. (350 F.Supp. at 1225; App., p. A5) The Court of Appeals held that if respondent were negligent, the statute of limitations might have been tolled, but only "until a plaintiff obtain[ed] knowledge or through due diligence should have obtained knowledge of the underlying fraud." (Pet., p. A18) While the Court of Appeals did not

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response to the motion for summary judgment consisted largely of reliance on allegations of their complaints which respondent had denied. As this Court has recognized, the party responding to a motion for summary judgment cannot rely on allegations in his complaint which are denied when the movant supplies admissible evidence. *First National Bank of Arizona* v. *Cities Service Co.*, 391 U.S. 253, 289 (1968).

reach the question of petitioners' diligence, since it held in respondent's favor on other grounds, in a related case the District Court has held as a matter of law that these petitioners were not diligent in discovering Nay's fraud.*

CONCLUSION

For the foregoing reasons it is respectfully submitted that the petition for a writ of certiorari should be denied.

Respectfully submitted,

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* *Hochfelder* v. *Ernst & Ernst*, Case Nos. 71 C 454 and 71 C 1204 (N.D. Ill. August 1, 1973), *appeals pending*, Case Nos. 73-1907 and 73-1908 (7th Cir.). Ernst & Ernst, First Securities' accountant, was sued along with Midwest. In the cited opinion the District Court granted a summary judgment to Ernst & Ernst on the statute of limitations and other grounds and on the statute of limitations point said:

> "Under *Parrent* v. *Midwest Rug Mills, Inc.*, 455 F.2d 123 (7th Cir. 1972), the statute is tolled if a plaintiff fails to discover the wrong without any fault or want of diligence or care on his part (455 F.2d at 128). In the case at bar, however, plaintiffs do not dispute the fact that they allowed Nay to conduct his improper activities and to conceal them from the defendant in various ways. Without denial, defendant has shown that plaintiffs made their investments in the form of checks payable to Nay individually, that they told the Internal Revenue Service as late as 1965 that Nay was paying interest to them on his personal indebtedness to them, and that they inaccurately confirmed their accounts at First Securities Company when requested by defendant to verify them. Thus plaintiffs not only did not exercise diligence or care to discover Ernst & Ernst's alleged negligence but they actively participated in causing this defendant's failure to discover the fraud when it audited First Securities Co. in 1967 and before. Acc. *Morgan* v. *Koch*, 419 F.2d 993 (7th Cir. 1969)."

APPENDIX

UNITED STATES DISTRICT COURT
NORTHERN DISTRICT OF ILLINOIS
EASTERN DIVISION

OLGA HOCHFELDER, THERESA W. ROTHERMEL, AGNES SMITH, EUGENE VIOTA, HELEN B. FELDKAMP, ANNA L. JESSE, WILLIAM P. JESSE, ERIC W. STUBBS, LURENTA T. STUBBS, HELEN C. ALLISON, LEON W. CARNOVSKY, ZERAH A. DRAKE, JOHN M. JACKSON, TRUSTEE, JOHN M. JACKSON, INDIVIDUALLY, AND ELIZABETH B. JACKSON,
Plaintiffs,

vs.

MIDWEST STOCK EXCHANGE and ERNST & ERNST,
Defendants.

No. 71 C 454

DECISION and ORDER

This cause comes on to be heard on the motion of defendant Midwest Stock Exchange for summary judgment or, in the alternative, for partial summary judgment. The defendant's motion was also filed with respect to the related case 71 C 1204, but the plaintiffs in that case have not yet filed their response. Since the attorneys for the plaintiffs in 71 C 1204 have represented in open court that the two cases are distinguishable, we will proceed to decide only 71 C 454 on the present pleadings. We find and conclude that the motion of defendant Midwest Stock Exchange in this case should be granted.

Plaintiffs' amended complaint against Midwest is founded on Section 10b of the Securities Exchange Act of 1934 (15

U.S.C. § 78j(b)) and S.E.C. Rule 10b-5 thereunder (17 C.F.R. § 240.10b-5). Apparently as part of the 10b-5 violation, plaintiffs also allege that this defendant violated Section 6(a)(1) of the Securities Exchange Act (15 U.S.C. § 78f). This section, in part, requires a national securities exchange to file an agreement with the S.E.C. "to enforce so far as is within its powers compliance by its members, with the provisions of this chapter, and any amendment thereto and any rule or regulation made or to be made thereunder." Presumably such an agreement was filed by Midwest.

The background facts of this case are fully set forth in two recent opinions of the Seventh Circuit Court of Appeals in cases #71-1272 dated April 12, 1972 and #71-1422 dated August 1, 1972. The liability of Nay and his brokerage firm has thereby been established. These decisions also control some of the defendant's defenses. There is therefore no need to further review the sordid details except insofar as they relate to plaintiffs' claim against Midwest.

The facts insofar as Midwest's defenses are concerned are contained in several affidavits filed with its motion demonstrating its relationship to Nay and First Securities. These facts are not controverted by any counter-affidavits. The remaining question, therefore, is whether any genuine issues of material fact exists between the parties to this litigation. We believe there are none and that the only issues remaining to be decided are issues of law.

Insofar as any affirmative representation by Midwest is concerned, plaintiffs rely almost entirely on a certificate issued to Nay which was presumably displayed in his office and which stated:

A3

MIDWEST STOCK EXCHANGE

Organized 1882

An Association for Brokers, Whose Object is to Establish and Conduct a Market for Listed Securities, where High Standards of Commercial Honor and Integrity are maintained and Just and Equitable Principles of Trade and Business prevail.

This certificate of Membership is Issued to

LESTON B. NAY
of
First Securities Company of Chicago

/s/ Carl E. Ogren
Secretary

/s/ James E. Day
President

(This Certificate is the Property of
Midwest Stock Exchange)

Since Nay's dishonesty did not involve the sale of "listed securities" to plaintiffs, this certificate is not evidence of any violation of Rule 10b-5. It does not apply to the sale or issuance by Nay of promissory notes in his personal escrow account, and plaintiffs do not allege any impropriety in the purchase or sale of listed securities. They would not have been justified in relying on this certificate when they turned over the proceeds of sales of securities to Nay personally, and affirmative representations under Rule 10b-5 are required to be in connection with the purchase or sale of the security in question. Cf. *List* v. *Fashion Park Inc.*, 340 F.2d 457, 462-3 (2nd Cir. 1965), *cert. den.*, 382 U.S. 811 (1965), *Katz* v. *Amos Treat & Co.*, 411 F.2d 1046, 1053 (2nd Cir. 1969).

The remainder of plaintiffs' allegations against this defendant involve its alleged failure to investigate and supervise Nay's activities sufficiently to discover his fraud. No

case has been cited where this type of omission or practice gives rise to an action against an exchange under Rule 10b-5. The only cited case resulted in summary judgment for the exchange. *Butterman* v. *Walston & Co., Inc. et al.*, 387 F.2d 822 (7th Cir. 1967). As a matter of fact, it is doubtful that the language of Section 6(a)(1) supports an action by a third party except possibly as a contract beneficiary.

The other cited cases involve representations or omissions made with respect to the issuance or sale of specific securities. There is no indication that Rule 10b-5 was intended to make a national security exchange responsible for all of the personal transactions and financial stability of its members. Cf. *Buttrey* v. *Merrill Lynch et al.*, 410 F.2d 135 (7th Cir. 1969) for a typical case involving violations of a stock exchange rule by a broker.

Assuming, however, that Midwest could be liable for ineffectively policing its members' dealings in unlisted securities, the defendant's affidavits demonstrate that it adequately performed its agreement under Section 6(a)(1) of the Act. Although plaintiffs have shown instances where this defendant arguably was put on notice of Nay's untrustworthiness, these do not raise an issue of fact concerning the adequacy of the defendant's supervision, but merely tend to show that it was not fluoroscopic. Neither the law nor common sense requires perfection but only an agreement "to enforce so far as is within its powers compliance by its members. . . ." (15 U.S.C. § 78f). Defendant's affidavits establish this without contradiction.

The words of the Court of Appeals in #71-1422 involving a customer's claim against the broker are somewhat *apropos* to Midwest's position in this case:

> Nothing which occurred during the almost 25 years of Schueren's dealings with First Securities and Nay can be said to have put a reasonable person on notice that anything was amiss. . . . Even the trust department of the Union Bank was completely duped by Nay for more than a year after Schueren's death until Nay's suicide.

The court finds and concludes as a matter of law that Midwest performed its obligations under Section 6(a)(1) and that no triable issue of fact remains therein.

There is no longer any issue in this case that Nay violated Rule 10b-5 and committed fraud in the sale of "securities" (Case #71-1422, Seventh Circuit, August 1, 1972). It must also be assumed that he violated one or more of defendant's rules and regulation. This does not constitute fraudulent conduct by the defendant exchange, as occurred in *Carroll* v. *First National Bank of Lincolnwood*, 413 F.2d 353 (7th Cir. 1969), *cert. den.* 396 U.S. 1002 (1970). It also cannot be said from any of the facts or alleged facts in this case that defendant Midwest "aided and abetted" Nay in any actionable sense. *Wessel* v. *Buhler*, 437 F.2d 278 (9th Cir. 1971); see also *Brennan* v. *Midwestern United Life Insurance Company*, 417 F.2d 147, 154-5 (7th Cir. 1969), *cert. den.* 397 U.S. 989 (1970).

Defendant Midwest alternately contends that the three-year statute of limitations had run by the time this case was filed on February 19, 1971. Plaintiffs contend that the statute was tolled by fraudulent concealment, but the facts do not support this theory either. To toll the statute, the defendant must have actively concealed the cause of action, and Midwest clearly was not shown to have done this. The law on this point was not shown to be different than it was in *Morgan* v. *Kock*, 419 F.2d 993 (7th Cir. 1969). Since none of the plaintiffs entrusted funds to Nay after 1966, their claims are barred.

IT IS THEREFORE ORDERED, ADJUDGED AND DECREED that defendant Midwest Stock Exchange's Motion for Summary Judgment is granted, and this case is set for a status report along with No. 71 C 1204 on Wednesday October 11, 1972 at 10 a.m.

Enter:

/s/ Thomas R. McMillen
Judge, U.S. District Court

Oct. 3, 1972

FILED
JUL 15 1974
MICHAEL RODAK, JR., CLERK

No. 73-1828

In the
Supreme Court of the United States
October Term, 1973

OLGA HOCHFELDER, et al.,
Petitioners,

vs.

MIDWEST STOCK EXCHANGE,
Respondent,

LEON S. MARTIN, et al.,
Petitioners,

vs.

MIDWEST STOCK EXCHANGE,
Respondent.

REPLY OF PETITIONERS FOR CERTIORARI TO BRIEF OF RESPONDENT

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IN THE

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OCTOBER TERM, 1973

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Respondent.

REPLY OF PETITIONERS FOR CERTIORARI TO BRIEF OF RESPONDENT

We reply, not to traverse the many misrepresentations of Respondent, but only to point out one gross error which might seriously mislead this Court.

Respondent argues (Br. 11) that both courts below reached the same conclusion and that the case therefor falls within the wise rule of this Court that certiorari will not be granted, in the absence of a very exceptional showing of error, where two courts below have made con-

current findings. But here there were no concurrent findings. The trial court specifically found that Midwest was "arguably put on notice of Nay's untrustworthiness." (350 F. Supp. at 1124) The trial court based its summary judgment on the statute of limitations (350 F. Supp. 1125). The Court of Appeals disowned this basis for its summary judgment. (Pet. A 17-18) The trial court also based its summary judgment on its construction of Midwest's plaque as limited to the sale of listed securities and its assertion that "Nay's dishonesty did not involve the sale of listed securities." (350 F. Supp. at 1124) But the Court of Appeals was compelled to eliminate this basis for a summary judgment when petitioners cited *Etting* v. *U. S. Bank*, 1826, 24 U.S. 59, 74 and the many cases following that opinion of Chief Justice Marshall that no court can take a case from the jury on the construction of a writing where the issue is the effect that the writing was calculated to produce and did produce on others.

Since the Court of Appeals on motion for summary judgment has acted as a finder of facts, we submit that this Court in accordance with its prior practice should grant certiorari and reverse the case for trial. For this Court to allow the opinion of the Court of Appeals to stand will practically eliminate from the statute book Section 6 of the 1934 Securities Act.

Respectfully submitted,

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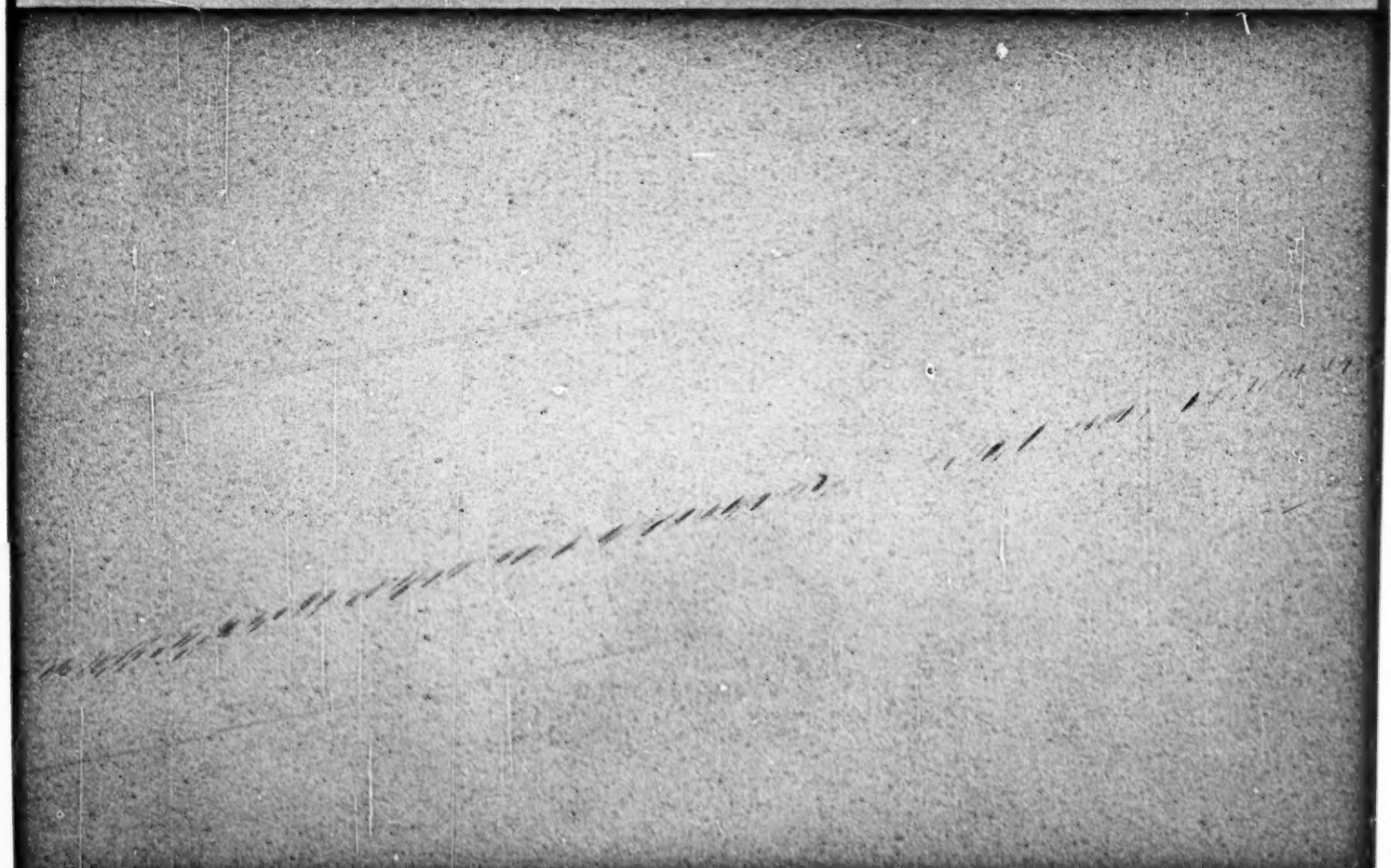

SUPREME COURT, U. S.

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Respondent.

RESPONDENT'S SUPPLEMENTAL BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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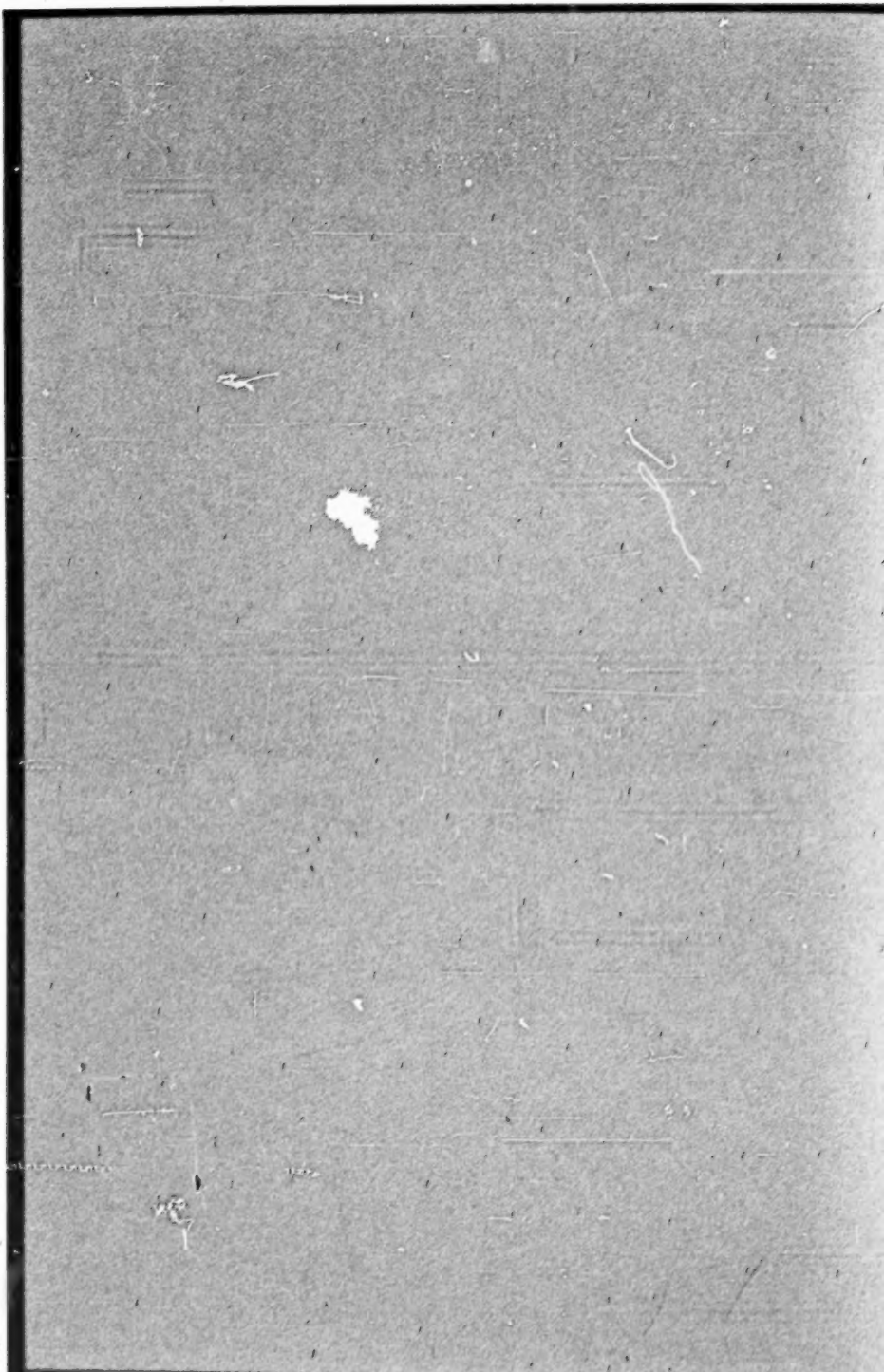

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MIDWEST STOCK EXCHANGE,

Respondent.

RESPONDENT'S SUPPLEMENTAL BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

In Respondent's Brief in Opposition to Petition for Writ of Certiorari filed herein on July 2, 1974, respondent Midwest Stock Exchange cited the district court opinion in the related cases styled *Hochfelder* v. *Ernst & Ernst,* Case Nos. 71 C 454 and 71 C 1204 (N.D.Ill. August 1, 1973) (Brief in Opposition, p. 13 n.*), in support of its contention that there are alternative grounds for entering judgment for respondent apart from the bases on which the Court of Appeals ruled. Specifically, the Brief in Opposition pointed out that in the related cases against Ernst & Ernst, auditor

for First Securities Company of Chicago, the district court had held as a matter of law that the claims of the plaintiffs, who are the same as in the instant cases, were barred by the statute of limitations on the ground that plaintiffs had not acted diligently in discovering Nay's fraud.

We wish to advise the Court that that district court decision has been reversed. *Hochfelder* v. *Ernst & Ernst,* Case Nos. 73-1907 and 73-1908, CCH Fed. Sec. L. Rep. ¶ 94,781 (7th Cir. August 30, 1974) [Current Binder]. The Court of Appeals held, *inter alia,* that there were genuine issues of fact on the statute of limitations question and remanded the cases for a trial. Of course, nothing in that opinion constitutes a holding that plaintiffs were in fact diligent, only that there are questions of fact on that issue.

Moreover, nothing in the cited opinion casts any doubt upon the legal principles applied or the result reached by the Court of Appeals herein. The major difference between the decision in the cases involving Ernst & Ernst and the instant cases involving respondent Midwest Stock Exchange is that the same panel of the Court of Appeals held that there were genuine issues of material fact in the former cases but not in the instant cases.

Respondent therefore again urges that the petition be denied.

Respectfully submitted,

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